



Tax Laws Amendment (Loss Recoupment Rules and Other Measures) Bill 2005

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Law and Bills Digest and Economics, Commerce and Industrial Relations Sections

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Tax Laws Amendment (Loss Recoupment Rules and Other Measures) Bill 2005

Date Introduced: 14 September 2005

House: House of Representatives

Portfolio: Treasury

Commencement: Sections 1 to 3, Schedules 1 to 4, 6 and 7, and Schedule 5 with the exception of item 16, on the day on which the Act receives Royal Assent; and Schedule 5, item 16 immediately after the commencement of the provision(s) covered by table item 3.

Background

The House of Representatives passed the Tax Laws Amendment (Loss Recoupment Rules and Other Measures) Bill 2005 (the Bill) on 12 October 2005. The Bill was introduced in the Senate on the same day where debate on the Second Reading Speech was adjourned.

On 11 October 2005, the Bill was referred to the Senate Selection of Bills Committee by Mr Joel Fitzgibbon MP (ALP) for the following reasons:

Schedule 1 may constitute a disincentive for investment in mining.

Schedule 2 requires further discussion in relation to the policy intent of the measure.¹

On 12 October 2005, the Senate referred the provisions of the Bill to the Economics Legislation Committee for inquiry and report by 8 November 2005. Submissions, due by 21 October 2005, will be available on the Committee's website at http://www.aph.gov.au/Senate/committee/economics_ctte/recoupment/index.htm.

The background and purpose of each of **Schedules 1 to 7** are detailed below with reference to the [Explanatory Memorandum](#).

Purpose

Schedule 1 – Loss recoupment rules for companies

At present, companies can deduct losses incurred in earlier income years if they satisfy either the continuity of ownership test (COT) or the same business test (SBT). The COT requires that the same persons have more than 50% of a company's voting power, hold

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rights to 50% or more of the company's dividends and capital distributions during the period from the start of the loss year to the end of the income year.²

If a company does not meet the conditions for the COT, or if it is impracticable to show whether or not a company meets those requirements, the company may apply the SBT. The company satisfies the same business test if throughout the year in which it wants to claim the loss it carries on the same business as it carried on immediately before then, and does not derive income from a new business or transaction.³

A modified COT can be used by *listed public companies and their wholly-owned subsidiaries*. The existing modified test uses a 'substantial continuity of ownership test' (SCOT). The SCOT is similar to the COT, but requires testing to be applied at defined times, rather than continuously throughout the relevant period.⁴

In April 2004, Senator Helen Coonan, then Minister for Revenue and Assistant Treasurer, announced planned changes to the regime, under which 'a simplified COT will be provided for all widely held companies and a broader range of subsidiary companies. In addition, the simplified COT will replace the SBT for large companies and large consolidated groups.'⁵ The Minister also announced the intention to prevent the use of the SBT by companies in an income year in which their total income exceeds \$100 million.⁶

The *Explanatory Memorandum* states that these reforms should reduce compliance costs as eligible companies will be able to apply the new modified COT. It is also anticipated that it will reduce the Australian Taxation Office's administrative costs as there will be fewer requests for rulings and company audits will be simplified.⁷

The COT changes will apply to losses incurred in income years commencing on or after 1 July 2002 and to certain other eligible losses incurred before that date. The Government announced in its 2005-2006 Budget that it would defer the SBT changes for one year.⁸ The SBT changes will generally apply to income years commencing on or after 1 July 2005.

Schedule 2 – Conduit foreign income

As a continuance of the Government's reform of Australia's international tax arrangements, **Schedule 2** allows Australian companies which receive foreign income on which no Australian tax is payable, to pay dividends to foreign shareholders free of Australian withholding tax.

Conduit foreign income can be described as foreign income for foreign residents which has been received by an Australian corporate entity. Under the proposed changes, foreign residents would be provided with a tax relief where they receive foreign income through Australian corporate tax entities. *Tax News Network Australia* summarised the effect of the proposed taxation rules as follows:

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These rules will allow Australian companies that receive foreign income on which no Australian tax is payable to pay dividends to foreign shareholders that are also free of Australian withholding tax.⁹

According to the *Explanatory Memorandum*, much of the income which flows from the foreign company to an Australian company will be exempt from Australian taxes. Consequentially, when distributed to foreign shareholders, the amounts distributed would be subject to withholding tax under section 128 of the *Income Tax Assessment Act 1936* (ITAA 1936). The tax measures in **Schedule 2** are designed to ensure that the flow of foreign income from foreign entities to foreign owners will not attract taxation when flowing through the Australian company.

Schedule 2 sets out how a corporate tax entity will calculate an amount of conduit foreign income and how such income can pass through a series of Australian corporate tax entities to foreign owners without the payment of Australian tax.¹⁰

Schedule 3 – Denial of deductions for illegal activities

Schedule 3 is a direct response to the Full Federal Court decision in *Commissioner of Taxation v La Rosa* [2003] FCA 125 in which the court held that Mr La Rosa, a convicted drug dealer, was entitled to a deduction for a loss incurred in earning his income as a drug dealer. The High Court subsequently refused the Commissioner of Taxation special leave to appeal.¹¹

Therefore, under current law, income earned through illegal means is considered ordinary income and the general deduction provisions of the *Income Tax Assessment Act 1997* (ITAA 1997) apply, as do the capital gains tax provisions.

The Bill amends the ITAA 1997 by preventing deductions for expenditure related to illegal activities for which the relevant person has been convicted, as long as the offence is punishable by imprisonment for at least one year. Losses and outgoings incurred in relation to those same activities will not be able to form part of the costs base or reduced cost base for capital gains purposes. This will apply to wholly illegal activities such as drug dealing and people smuggling. If a conviction relates to an illegal activity undertaken by an otherwise lawful business, then deductions will be denied in respect of those activities of the business to which the conviction relates.¹² These changes are effective after 29 April 2005.

Schedule 4 – Copyright in film to be included in effective life depreciation

Schedule 4 of the Bill deals with the calculation of depreciation (decline in value), for taxation purposes, of a particular kind of intangible asset; copyright in films. Depreciation is a deduction in the calculation of taxable income.

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The Bill changes the way that depreciation may be calculated by allowing the asset (film copyright) to be depreciated over a shorter or longer period than the current legislation permits. Currently, for intangible assets, like copyright, the ‘effective life’ of an asset is prescribed in the legislation and there is no option for choosing another period. The effective life is the period over which the asset is taken to be used for taxable purposes and is the period over which it may be depreciated. For non-Australian films, the effective life is currently 25 years.

These amendments are concerned only with non-Australian films. Australian films are dealt with specifically in Divisions 10B and 10BA of the ITAA 1936.

The legislative mechanism by which these changes are effected is that film copyright is brought within the ambit of the existing ‘uniform capital allowances’ system. That system provides a mechanism for working out the decline in value of assets generally. Currently, film copyright is expressly excluded from the system. These amendments remove the exclusion (thereby *including* film copyright).

One element of the uniform capital allowances system is the determination of the ‘effective life’ of an asset. Unlike the current position for film copyright, the uniform capital allowances system provides for alternative ways of determining the effective life of an asset. The alternative mechanisms are:

- use the effective life determination made by the Commissioner for a range of assets (the ‘safe harbour’ determination), or
- self assessment. This option must be used for assets for which the Commissioner has not made a determination.

These amendments therefore provide for flexibility in place of the current rigid system for determining the period over which film copyright may be depreciated.

Schedule 5 – Relief for employee share scheme participants

An employee share scheme (ESS) is a scheme whereby an employee acquires shares or rights in connection with their employment at less than market value; that discount is assessable as income. Subject to certain conditions, an ESS participant can access tax concessions in relation to the discounts under section 26AAC or Division 13A of the ITAA 1936 depending on the date of acquisition.¹³

The **Schedule 5** amendments will mean that in circumstances where, as a result of a corporate restructure or 100% takeover, an employee is issued new rights or shares, these will be viewed as a continuation of their old shares or rights to the extent that the new shares or rights match those previously held. Consequently, ESS participants will be able to claim a continuation of the same concessions in those situations as a taxing point will not arise; and, as there will be continuity of treatment, they will not be liable for the capital gains tax they would have otherwise incurred on disposal of their old shares or rights.¹⁴

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Schedule 6 - Offsetting penalties for late payment of Superannuation Guarantee obligations

Schedule 6 amends the ITAA 1997 and the *Superannuation Guarantee (Administration) Act 1992* (SGA). These provisions allow a late payment (within set time limits) of an employer's Superannuation Guarantee obligations to partly offset penalties arising from making these payments outside the required time limits.

Commencing operation on 1 July 1992, the Superannuation Guarantee regime requires employers to pay 9 per cent of an employee's ordinary time earnings into a superannuation fund or retirement savings account nominated by the employee or the Superannuation Holding Accounts Special Account (known as SHASA) where the employer cannot reasonably find any other superannuation fund/account into which to make these payments.¹⁵ Payments are required to be made within 28 days of the end of each calendar year quarter.¹⁶

Under the current provisions of the SGA, substantial penalties apply to employers if Superannuation Guarantee payments are either not made, or payments for the relevant quarter are made later than 28 days after the quarter finishes. These penalties are:

1. an administration fee of \$20 for each employee for whom there has been an underpayment, or late payment, of contributions,¹⁷ plus
2. 9 per cent of the salary and wages of each employee for whom an under payment or late payment is made. Salary and wages are the basis of calculation of the penalty, rather than the generally lower ordinary time earnings,¹⁸ plus
3. a 10 per cent per annum interest calculated from the start of the relevant quarter rather than from the date the contributions should have been made,¹⁹ and
4. the above penalties are not tax deductible to the employer, whereas the superannuation contribution made on or before the due date would have been.²⁰

The first three penalties (individually known as 'Superannuation Guarantee Shortfalls')²¹ are automatic and apply even if the contributions are made shortly after the due date. Together with penalties for not keeping proper records the first three of the above penalties make up the 'Superannuation Guarantee Charge'.²² The notional interest component and the 9 per cent of salary and wages are paid to the employee's superannuation fund or other account by the Australian Taxation Office.²³

Briefly, the proposed measures would allow an employer's payment of their Superannuation Guarantee obligations to offset the second and third of the above penalties only if these payments are made within a further 28 day period following the due date. As noted above, the due date for an employer's Superannuation Guarantee contributions is 28 days after the end of the relevant calendar year quarter.

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If the payment was made within this additional 28 day period, the employer would still have to pay the first of these penalties (the administrative fee) and the payments would still not be tax deductible.

The time limit for making the appropriate Superannuation Guarantee contributions is quite strict. If the employer is only one day late in making these contributions, the full range of the above penalties applies. The proposal essentially gives employers a further 28 days to make the appropriate contribution so that the penalty is partly offset and thus introduces additional flexibility for employers in managing their superannuation contributions.

As reduced penalties will still apply if late contributions are made employers will still have an incentive to make these payments within 28 days of the close of the relevant calendar year quarter.

On the other hand, employers have all of the relevant quarter, plus the additional 28 days after the end of the quarter, to make the appropriate payments. It could be argued that current arrangements allow employers sufficient flexibility to manage their Superannuation Guarantee contributions. As the proposal reduces the incentive to make payments by the due date, this proposal may lead to abuse of the Superannuation Guarantee regime by employers.

Schedule 7 - Applying Superannuation Guarantee obligations to the back payment of wages

Currently, under section 19 of the SGA, the penalties only apply where a person is an employee. Though not free from doubt, the SG penalties do not apply where a person ceases to be an employee.²⁴ **Schedule 7**, in amending the ITAA 1936, ITAA 1997, and the SGA, addresses this problem by ensuring that employers make Superannuation Guarantee payments to former employees, who receive wages or salary in any quarter following the ending of the employment relationship.

This proposal will ensure that all of an employee's Superannuation Guarantee entitlements are paid in full. It may also reduce any incentive to release employees simply to reduce an employer's short-term Superannuation Guarantee obligations.

See bolded comment on page 21 of this digest concerning a drafting issue.

Basis of policy commitment

The **Schedule 1** provisions relating to tax loss recoupment rules for companies are the result of three years of consultations between the Government and business. Prior to Treasury's release of an Exposure Draft Bill on Loss Recoupment Rules for Companies on 11 February 2005,²⁵ the Government had noted, in relation to the proposed reforms, that:

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Submissions received by Government indicate companies excessively rely on the SBT to recoup prior year losses because of growing uncertainty and cost associated with demonstrating the COT has been met.²⁶

The Government's response has been to simplify the COT so as to make it easier for widely held companies, such as listed companies, as well as institutional managed and superannuation funds, which have many small portfolio shareholdings, to comply with the test. For some of these companies, tracing ownership has proven difficult because of the different classes of shares and the large number of shares traded, which of itself may not make for any material change in ownership of the company.²⁷ New tracing provisions address this problem.

On changes to the SBT, however, the Government was not able to achieve a consensus:

The Government has also received submissions about the practical difficulties experience by large companies and consolidated groups in complying with the SBT, and the associated uncertainty and cost that this causes. The Government recognises the practical difficulties that can arise when comparing the nature of a large business across two points in time, which may be several years apart. However despite lengthy consultation with key business organisations, no acceptable solution to improve the operation of the SBT has been identified.²⁸

The Government has therefore lifted the threshold of application to companies with a total income of more than \$100 million so as to reduce the number of companies able to use the SBT.

Schedule 2 continues the reform process, which formed part of the 2003 federal budget, of Australia's international tax arrangements. The proposed changes must be seen in the context of Australia's endeavour:

To maintain Australia's status as an attractive place for business and investment [...].²⁹

According to the Assistant Treasurer, the proposed rules aim at making:

Australia a more attractive base for multinationals looking to establish regional headquarters. It also benefits Australian-based multinationals by enhancing their ability to compete for foreign capital.³⁰

The rules are based on Recommendation 3.11(1) of the [Review of International Taxation Arrangements—A Report to the Treasurer](#) which reads:

The Board recommends proceeding with the foreign income account rules recommended by the Review of Business Taxation as they apply to direct investment flows (such as non-portfolio dividends and branch profits but excluding capital gains, portfolio dividends or similar types of income such as interest and royalties).³¹

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On 17 June 2005, the Treasury released an [exposure draft](#) detailing proposed conduit foreign income measures and invited submissions from the public. Submissions closed on 20 July 2005 and three submissions have been [published](#) on the Treasury's webpage. The measures proposed in this Bill are the result of this consultation process.

As noted, **Schedule 3** is a direct response to the La Rosa case. The Treasurer announced on 29 April 2005 that the law would be amended and would apply to expenditure incurred after that date. He also noted that the amendments would not replace or in any way diminish federal, state or territory powers to confiscate the proceeds of crime.³²

Schedule 4 sets out provisions for film copyright to be included in the effective life depreciation regime. Currently, films may not qualify for concessional treatment under Divisions 10B and 10BA of the ITAA 1936 because they lack sufficient Australian content or, even though funded by Australian taxpayers, are made overseas. Under the amendments, taxpayers may write-off copyright expenses in a film over a period based on the film's effective life rather than the current statutory 25 year period for copyrights. Taxpayers will also be able to choose between a 'safe harbour' effective life determination or self assessment of the effective life of copyright in a film.³³ The new provisions apply to copyright in a film acquired on or after 1 July 2004.

Of the changes included in **Schedule 5** relating to ESSs, the *Explanatory Memorandum* notes that these have not previously been announced. This is correct in that the Government did not release a Draft Exposure Bill detailing the amendments. However, the amendments were flagged in the Government's response to Recommendation 30 of the 2000 Nelson Report on Employee Share Ownership³⁴ in which the Government considered it appropriate:

...to provide rollover for employees in the event of a corporate restructure where both their employment and the schemes in which they participate remain substantially the same.³⁵

The **Schedule 6** measures applying to late payments of superannuation contributions by employers, and the **Schedule 7** measures applying the Superannuation Guarantee to back payments of wages, were announced in the 2005–06 Budget on 10 May 2005.³⁶

Position of significant interest groups/press commentary

Responses to the **Schedule 1** amendments have been mixed. According to KPMG Corporate Finance partner, Antony Cohen:

Companies in the resource sector will be one of the most affected groups as they have large upfront costs with deferred revenue streams, but rely on capital raisings or M&As to finance growth ...

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The post-tax returns of any acquisition may well be significantly different under this regime.³⁷

The Institute of Chartered Accountants tax counsel expressed similar reservations³⁸ as have Allens Arthur Robinson:

The proposed reforms ... are a substantial improvement to the current position ... However, in an acquisition context, the SBT ceiling will have a major impact on the value purchasers are prepared to attribute to a target company's losses. In many cases, these losses will automatically be taken out of the tax system as a result of the sale.³⁹

Likewise, PriceWaterhouseCoopers notes that there will be disappointment that the Government has ignored submissions on proposed changes to the SBT. The group also questioned the Government's justification for lifting the income threshold to \$100 million because large companies have difficulty passing the SBT:

Whilst this is true (particularly for consolidated groups), the Australian corporate sector includes many large "single business" companies which would have strong arguments that they carry on the same business.

As always, revenue considerations probably best explain the Government's stance: the denial of the SBT for the big end of town is the price that corporate Australia is being asked to pay in return for simplified COT tracking rules.⁴⁰

PriceWaterhouseCoopers supports the policy behind the modified COT rules, that is, to make it easier for businesses to pass this test, but places a rider on its support: 'it is to be hoped that the new laws will be administered with that policy intent in mind.'⁴¹ Other tax advisers, including Ernst & Young, also support the COT changes.⁴²

The **Schedule 2** amendments have received support from KPMG and the Corporate Tax Association, for bringing Australia's tax competitiveness in line with countries such as Hong Kong and New Zealand which do not tax conduit foreign income.⁴³

Of the **Schedule 5** amendments, Allens Arthur Robinson raises a number of concerns in its June 2005 publication, including:

- the scope of the terms '100% takeover' and 'restructure'
- confusion as to the CGT position of an employee who has elected to pay tax on grant of options, and
- failure to address the acquisition of shares under a \$1000 tax exempt scheme.

The firm concluded:

While there are clearly some problems with the limited scope of the rules (which no doubt will lead to lots of class ruling applications), there is a potential unexpected upside for employees holding restricted tax deferred shares.⁴⁴

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The publication is available at: <http://www.aar.com.au/pubs/tax/fotmajun05.htm> (though note that the article incorrectly states that the provisions are ‘now law’).

Those measures affecting superannuation contained in **Schedules 6** and **7** have been well received by both business and superannuation industry groups.⁴⁵ The Association of Superannuation Funds of Australia (ASFA) fully supports both measures⁴⁶ with the Chief Executive, Philippa Smith, reportedly commenting that it would reduce the harshness of current rules:

If a cheque was delayed or there was a simple miscalculation and the employer needed to correct it, there was no discretion allowed for employers trying to do the right thing.⁴⁷

ALP/Australian Democrat/Greens policy position/commitments

Mr Fitzgibbon MP (ALP) moved a second reading amendment in relation to both **Schedules 1** and **2**, and the Government’s ‘failure to advance meaningful tax reform’.⁴⁸ On the **Schedule 1** measures, he supported the policy intent of reducing compliance on business, but noted that the new COT regime was ‘potentially a major barrier to investment’⁴⁹ in a number of sectors. He referred to:

... concern in the business community, particularly in the areas of joint ventures, innovation and mining exploration companies, where returns on investment can be some years down the track from the original investment.⁵⁰

Mr Fitzgibbon further questioned the government’s failure to provide a clear policy justification for the changes in **Schedule 2**⁵¹ especially in light of the not insignificant cost of \$70 million.⁵²

Mr Fitzgibbon noted that **Schedules 3** to **7** were not controversial and have bipartisan support.

Mr Hatton MP (ALP) noted, in relation to **Schedule 1**, that people within the mining and resource industries had questioned the effectiveness of the new rules. He also queried why the financial impact is not quantifiable; and whether it is possible to quantify the compliance costs.⁵³

To date, the Australian Democrats and the Australian Greens have not commented on the Bill.

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Main Provisions

Schedule 1 – Loss recoupment rules for companies etc.

Schedule 1 amends the ITAA 1936 and the ITAA 1997 to give effect to the government's policy as outlined above. The main effects will be:

- The new modified COT will change the times at which the test of ownership is applied – currently at the start of each test period, and at each abnormal trade and the end of each income year – to the end of each test period, the end of each income year and the end of specified 'corporate change' events.
- The new modified COT will be available for use by 'widely held' companies – which is defined to mean companies listed on approved stock exchanges, and companies having more than 50 members except where 20 or fewer people control or have rights to 75% of the company's shares, 75% of the voting power of the company or 75% of dividends paid by the company. A company is also 'widely held' if it is a Division 166 company, which means that more than 50% of its voting power, rights to dividends or capital distributions are held by:
 - widely held companies;
 - superannuation funds;
 - approved deposit funds;
 - special companies;
 - managed investment schemes;
 - entities that are prescribed under the tracing rule that deems entities to be beneficial owners;
 - non-profit companies; or
 - charitable institutions.

The existing modified COT rule is available only to listed companies and their wholly-owned subsidiaries.

- There are a number of 'tracing rules' provided to assist companies in complying with the COT.
 - All registered shareholdings carrying less than 10% of voting power will be taken to be controlled by one single notional entity.
 - Indirect holdings of less than 10% of voting power will be taken to be held by the top interposed entity (the entity in which the indirect stakeholder with less than 10% interest has a direct interest).

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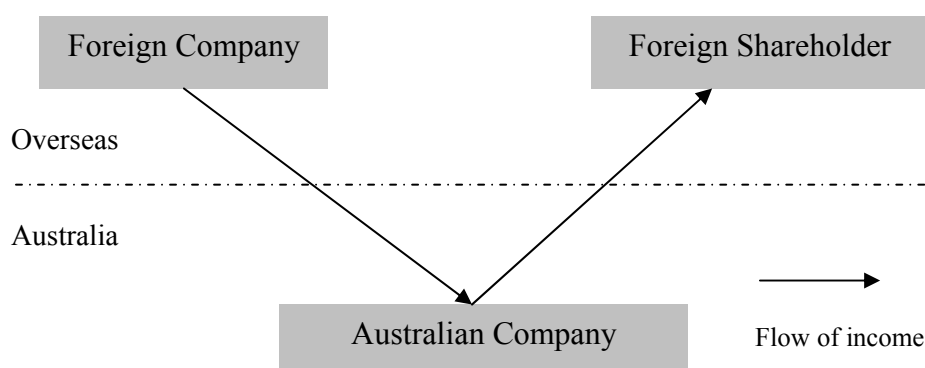
- Holdings of between 10% and 50% held by a widely held company will be attributed to the widely held company as ultimate owner.
 - Holdings by certain entities deemed to be beneficial owners will generally be attributed to that owner.
 - Indirect holders by way of bearer shares in a foreign company will, in some circumstances, be attributed to a single notional entity.
 - Indirect holdings by depository entities via shares in a foreign listed company will be attributed to the depository entity in defined circumstances.
- The SBT will not be available to companies with an income in excess of \$100 million for the income year in respect of which it intends to claim the loss.

Schedule 2 - Foreign residents' income with an underlying foreign source

Schedule 2, Part 1, Item 1 of the Bill will introduce proposed **new Division 802** into the ITAA 1997. This Division will lay down the rules for the taxation of foreign residents' income with an underlying foreign source.

Proposed **new Subdivision 802-A** will deal with one aspect of these rules, namely the rules relating to conduit foreign income.

Under proposed **new section 802-15**, conduit foreign income of Australian corporate tax entities (the entities) will be, under certain circumstances, exempt from Australian taxes. Under this provision, the entity's conduit foreign income will be non-assessable, non-exempt income of a foreign resident (that is, where the flow of income is from the foreign company to the Australian company—see diagram below) and will not be subject to withholding tax under section 128B of the ITAA 1936 (that is, where the income flow is from the Australian company to the foreign shareholder—see diagram below) (proposed **new subsection 802-15(1)**). The following simplified diagram, which is based on the diagram for example 5.1 of the [Explanatory Memorandum](#) to the Bill, may assist with the above explanation.⁵⁴



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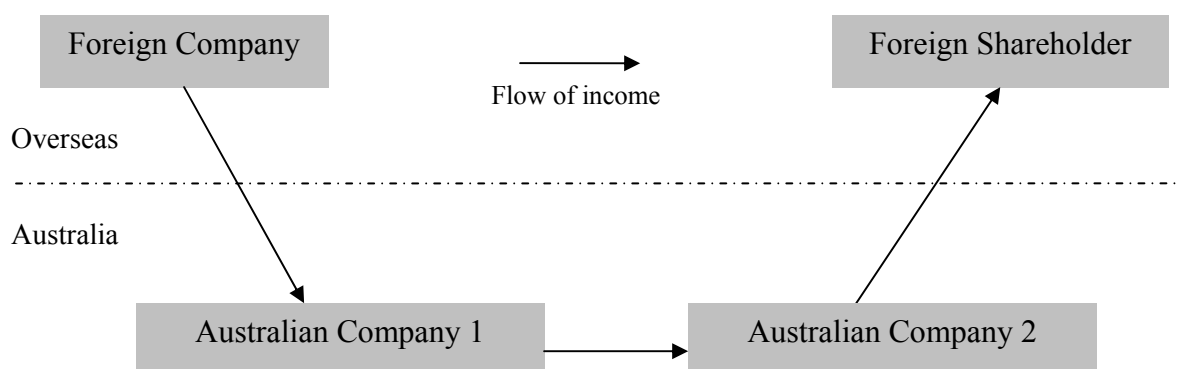
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Under certain circumstances, the new measure will also permit a tax-exempt flow of conduit foreign income through a chain of Australian entities. Under proposed **new section 802-20**, the conduit foreign income may flow through the Australian entities (in the diagram below called Australian Company 1 and 2) as non assessable, non-exempt income if the following three prerequisites are fulfilled:

- Australian Company 2 receives from Australian Company 1 an unfranked distribution which has an amount declared to be conduit foreign income
- Australian Company 2 makes an unfranked distribution it declares wholly, or in part, to be conduit foreign income, and
- Australian Company 2 makes the unfranked distribution, which it has declared to be conduit foreign income, within the required time.⁵⁵

The following simplified diagram may assist with this:



The result of this measure is that the conduit foreign income flows through Australian Companies 1 and 2 as non-assessable non-exempt income without attracting taxation. The amount of non-assessable non-exempt income is to be calculated by applying the formula set forth in proposed **new subsection 802-20(2)**. Further rules, including, for example, that a conduit foreign income amount can only be counted once, are set out in proposed **new subsections 802-20(3) to (5)**. The *Explanatory Memorandum* sets out detailed examples in relation to calculating non-assessable non-exempt income for the purpose of section 802-20 at page 132-4.⁵⁶

The amount of an entity's conduit foreign income is to be worked out under proposed **new section 802-25** which, in turn, refers to proposed **new sections 802-30 to 802-55**. These provisions contain the relevant rules for an entity to determine how much conduit income it can declare. Proposed **new section 802-30** contains the legislated formula according to which entities can calculate foreign source income amounts which are to be included in the conduit foreign income. Proposed **new section 802-35** stipulates which capital gains and losses have to be included in, or deducted from, the amount of conduit foreign income. Proposed **new subsection 802-35(3)** contains a timing rule, prescribing that the

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adjustment under **subsections 802-35(1) and (2)** are to be made at the end of the income year in which the capital gains tax event occurred. Under proposed **new section 802-40**, an entity must include foreign tax credits. The amount which has to be included in the conduit foreign income has to be calculated using the formula set forth in this section.

Where an entity has distributed frankable distributions with unfranked parts which have been declared to be foreign conduit income, then the entity will be entitled, under proposed **new section 802-45**, to reduce the amount of foreign conduit income to the extent of the unfranked parts that have been declared. This provision must be read together with proposed **new section 802-60** which deals with the situations in which an entity decides to stream distributions to particular shareholders. It stipulates that entities must not declare unfranked distributions to conduit foreign income and stream these distributions to foreign shareholders only. Proposed **new section 802-60** provides for an adjustment of the declared foreign conduit income in these situations. Where the entity has over-declared foreign conduit income, an administrative penalty will be applied under proposed **new Schedule 1, section 288-20** of the *Taxation Administration Act 1953* (the TAA) (as to this section, see discussion below). The *Explanatory Memorandum* sets out a detailed example in relation to streaming of conduit foreign income at page 135.

In case the entity has received unfranked distributions from another Australian entity, the conduit foreign income is further reduced if the requirements set out in proposed **new subsection 802-50** apply. These requirements include that:

- the entity receives frankable distributions which have an unfranked part
- the unfranked part, or parts thereof, are declared to be conduit foreign income, and
- the declared amount, or parts thereof, is non-assessable, non-exempt income under proposed new section 802-20.

No double benefits will be permitted under proposed **new section 802-55**.

Part 2 proposes various further amendments to the ITAA 1936 and ITAA 1997 which aim at full implementation of the rules for the taxation of foreign residents' income as discussed above. These amendments include, for example, modifications to the single entity and history entry rules in section 701-1(1) and 701-5 of the ITAA 1997 (**item 15**, proposed **new subdivision 715-U**). They also include the introduction of the administrative penalty regime for over-declaring foreign conduit income. **Item 25** will introduce proposed **new section 288-20** into the TAA. Where an entity has been over-declaring foreign conduit income, this section will provide that this entity is liable to an administrative penalty (proposed **new subsection 288-80(1)**). Proposed **new subsections 288-80(3) and (4)** contain the basis for the penalty, setting out formulae according to which the penalty amount is to be determined. The calculation of the penalty will depend upon whether the foreign conduit income is based on Australian or foreign membership interests. **New subsection 288-80(3)** deals with situations in which the entity has over-declared foreign conduit income based on the distribution on Australian membership

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interests. **New subsection 288-80(4)** deals with situations where the over-declaration occurred based on the distribution of foreign membership interests. The *Explanatory Memorandum* provides Example 5.10 which demonstrates the calculation of an administrative penalty.⁵⁷

Part 3 contains transitional provisions and consequential amendments. **Item 27** will provide guidance to entities whose income years start on or after 1 July 2005, but before the measure receives Royal Assent. **Item 28** will make provisions for all other entities.

Application and effect

The measures in **Schedule 2** will commence with Royal Assent and take effect from the beginning of the first income year that starts on or after 1 July 2005, but the effect can be modified by the transitional provisions referred to above.

Projected costs of the measures in Schedule 2

According to the *Explanatory Memorandum*, the cost of the measure is projected to be.⁵⁸

2005-6	2006-7	2008-9	2009-10	<i>per annum thereafter</i>
\$5million	\$20million	\$20million	\$25million	\$25million

The *Explanatory Memorandum* also foreshadows a possible increase in compliance costs for entities.⁵⁹

Schedule 3 – Denying deductions for illegal activity

Items 1 to 4 amend the ITAA 1997.

Item 2 inserts a **new section 26-53** which prevents deductions of a loss or outgoing to the extent that it was incurred in the furtherance of or directly in relation to an indictable offence for which the taxpayer was convicted. **New subsection 26-53(2)** provides that the Commissioner may amend an assessment at any time within four years after conviction for such an offence.

Item 3 inserts a **new section 110-38** which prevents the expenditure forming part of the cost base to the extent that the new section 26-53 prevents it being deducted.

Item 4 inserts a **new subsection 110-55(9A)** that similarly provides that such expenditure cannot form part of the reduced cost base, the formulate for which is set out in section 110-55.

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These amendments apply to amounts incurred after 29 April 2005 (**Item 5**).

Schedule 4 – Film copyright

Items 1 to 3 make amendments consequent upon those made by **Items 4 to 12** below by amending Division 10B of the *ITAA 1936*. Division 10B (along with Division 10BA) deals with the depreciation of copyright in Australian films. A two year write-off period currently applies to such copyright but a taxpayer can elect that this period not apply. If such an election is made the current position is that a 25 year write-off will apply under section 124U. **Item 2** repeals section 124U which is no longer needed as a result of the amendments made by **Items 4 to 12** below. **Items 1 and 3** make amendments to take account of the repeal of section 124U.

Items 4 to 12 amend the *ITAA 1997*.

Item 4 amends paragraph 40-70(2)(b) to remove film copyright from the list of assets in relation to which the diminishing value method of calculating depreciation cannot be used.

Item 5 amends table item 5 in paragraph 40-95(7) to remove film copyright from the list of intangible assets for which the legislation currently prescribes an effective life.

Item 6 amends table item 7 in paragraph 40-95(7) to remove film copyright *licences* from the list of intangible assets for which the legislation currently prescribes an effective life.

Item 7 makes a minor amendment to subsection 40-100(4). The provision sets out the factors which the Commissioner must take into account in working out the effective life of an asset. The factors are those applicable to tangible assets. The amendment provides that the Commissioner must take the factors into account only if they are relevant to the asset. Clearly, some factors are not relevant to intangible assets like copyright.

Item 8 makes a minor amendment to subsection 40-105(1). It is a similar amendment to that made by **Item 7** but it deals with the factors to be taken into account when the taxpayer self assesses the effective life of an asset.

Item 9 amends subsection 40-105(4) with the effect that film copyright and film copyright *licences* are removed from the list of assets in relation to which self assessment (of effective life) is not available. The effect is that self-assessment becomes available for film copyright.

Item 10 inserts a new note at the end of subsection 40-110(1) which lists examples of the changes in circumstances that may result in a need to re-calculate the effective life of a depreciating asset.

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Item 11 amends subsection 40-110(5) with the effect that film copyright and film copyright licences are removed from the list of assets in relation to which the effective life cannot be recalculated under the system of self assessment.

Item 12 provides that these amendments apply only to film copyright acquired after 1 July 2004.

Schedule 5 – Employee share schemes

Items 1 to 12 amend the ITAA 1936.

Item 3 inserts a **new section 26AAD** which covers the effect on the operation of section 26AAC of a 100% takeover and restructure of a company. Under section 26AAC, ESS participants can access either a tax-excluded or a tax-deferred discount. The amendments provide that, subject to certain conditions, the acquisition by a taxpayer of shares or the right to acquire shares in a company ('the new company') that can reasonably be regarded as matching rights in another company ('the old company') that the taxpayer had acquired under an ESS, will be treated for the purposes of section 26AAC as a continuation of the shareholding in the old company. This is in circumstances where the acquisition occurs in connection with a 100% takeover, or a restructure, of the old company and as a result of that change, the taxpayer ceased to hold the shares or rights in the old company.

If the shares or rights acquired by the taxpayer do not match, it will be considered a share or rights disposal, for the purposes of section 26AAC.

There are three conditions for the continuation of shares or rights:

- immediately before the takeover or restructure, the taxpayer held shares or rights in the old company under an ESS;
- the matching shares or rights must be ordinary shares or rights respectively; and
- the matching shares or rights must be subject to the same conditions or restrictions or conditions or restrictions that have the same effect, as those that previously attached to the rights or shares held in the old company.

The result is that ESS participants who opt for the tax-excluded discount will not incur a capital gain or loss, and those who opt for the tax-deferred discount, will be able to continue the deferral period.⁶⁰

New subsection 26AAD(6) sets out the apportionment rules. These allow for the original consideration paid by the taxpayer for shares or rights in the old company to be spread out proportionately among all the apportionable assets according to their market values immediately after the takeover or restructure. Apportionable assets are defined in **new subsection 26AAD(7)** as those that are a continuation of the original shares or rights or can otherwise be reasonably regarded as matching those original shares or rights.

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Item 10 removes subsection 139DR(4) of the ITAA 1936 and thus provides the same relief for ESS participants who access the tax-upfront concession under Division 13A.⁶¹

Items 13 and 14 amend the ITAA 1997. **Item 13** inserts a **new subsection 115-30(1A)**. This amends the capital gains tax provision in line with the new section 26AAD in the ITAA 1936. **Item 14** notes that under section 139E of the ITAA 1936, an election by a taxpayer to be taxed upfront will not prevent a share or right from being treated as a continuation of the share or right acquired under an ESS. According to the *Explanatory Memorandum*, the amendment also ensures that:

- any capital gain or loss will be disregarded
- the same CGT cost base treatment will be retained, and
- ESS participants acquiring new shares will no longer have to satisfy the 3 year waiting period before disposing of shares.⁶²

Items 15 to 18 amend the *Income Tax (Transitional Provisions) Act 1997* to the effect that the treatment accorded an ESS participant under subdivision 130-DA, which provides that an ESS participant acquires a share or right at the time it was acquired by the trust, and the capital gains treatment afforded under subdivision 130-D, will extend to matching new shares or rights. **Items 19** similarly amends the *Taxation Laws Amendment Act (No. 3) 2003* to reflect the changes to the ITAA 1936.

Item 20 provides that the amendments apply to acquisitions of shares or rights on or after the day on which Schedule 5 commences.

Schedule 6 – Superannuation guarantee charge

Item 1 repeals a portion of **Section 12-5** of the ITAA 1997 and inserts a new portion denying the employer tax deductions for late payments of the Superannuation Guarantee obligations that partly offset the Superannuation Guarantee Charge (SGC).

Item 2 inserts new **section 26-85** into the ITAA 1997. This new section denies employers any tax deduction in respect of payments of Superannuation Guarantee amounts that they elect to offset their SGC liabilities.

Item 5 inserts **new section 23A** into the SGA. This new section allows a late payment of an employer's Superannuation Guarantee obligation to offset any SGC liabilities, but only where:

- such contributions are made within a 28 day period from the due date for the payment of the employer's Superannuation Guarantee obligations (the due date is itself 28 days after the end of the preceding calendar year quarter), and
- the employer elects, via an 'approved form', that this contribution offsets the SGC for the relevant quarter, and

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- this election is made within 4 years after the employer's SGC for the relevant quarter became payable.

New subsection 23A(3) stipulates that the offset will only cover the employer's nominal interest component or the employer's individual Superannuation Guarantee Shortfall for a particular quarter.

New subsection 23A(4) specifies that the offsetting contribution will first cover the nominal interest component with the remainder, if any, covering the employer's individual Superannuation Guarantee Shortfall for the relevant quarter.

Initially, employers determine their own compliance with the requirements of the SGA. Under section 33 of this Act, if employers have a Superannuation Guarantee Shortfall for the relevant quarter, they must lodge a 'Superannuation Guarantee Statement' with the Commissioner for Taxation by certain dates. These statements contain, amongst other things, the employer's nominal interest component, individual Superannuation Guarantee Shortfalls and the amount of the SGC for the relevant quarter.

Item 6 repeals current subsection 33(1) containing the dates for the lodgement of these statements and inserts a **new subsection 33(1)** containing new dates. These new dates reflect the additional 28 day period for the payment of Superannuation Guarantee amounts that offset any SGC liabilities.

Under subsection 35(1) of the SGA, once a Superannuation Guarantee Statement has been lodged an assessment of the employer's liability to the SGC is taken to have been made.

Item 7 substitutes a **new subparagraph 35(1)(d)**. This extends the dates on which an assessment of the employer's liability to pay the SGC is taken to have been made in line with the additional 28 day period to make a Superannuation Guarantee payment that partly offsets the employer's SGC liability.

Under current subsections 46(1) and (2) of the SGA an employer's SGC is payable on either the 'lodgement day' for that particular quarter, or if the Superannuation Guarantee Statement is lodged after a certain date, the day on which the Statement is submitted to the ATO. **Item 8** substitutes a **new subsection 46(2)** which changes the dates specified as 'lodgement days' for the purposes of submitting the Superannuation Guarantee Statement to the ATO. In effect, this changes the date on which the SGC is payable, if the Statement is lodged before the 'lodgement day'. Again, the dates are extended from the end of the relevant quarter to align them with the additional 28 day period for making Superannuation Guarantee Payments that partially offset an employer's Superannuation Charge Liability for that quarter.

Item 10 requires that different provisions in **Schedule 6** of the Bill take effect on different dates:

- the main operative provisions contained in **Items 1, 2, 4, 5 and 9** are to take effect on 1 January 2006

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- **items 3, 6 7 and 8**, covering the extension of dates for lodgement of a Superannuation Guarantee Statement, assessment of an employers Superannuation Charge Liability and the payment of any outstanding Superannuation Charge take effect, on 1 October 2005.

The reasons behind this difference in dates of effect are not readily apparent. However, no major difficulties appear to arise as a result of this difference.

Schedule 7 – Superannuation on back payments

Item 1 inserts a **new subsection 82AAC(1)** of the ITAA 1936. Generally, the subsection has been rewritten to allow a tax deduction for an employer in respect of any Superannuation Guarantee contributions, made by the due date (that is, within the relevant quarter or up to 28 days after the end of that quarter) paid on behalf of either former or current employees.

Though the *Explanatory Memorandum* is silent on the following point one commentator has noted that the proposed changes to subsection 82AAC(1) also clear up confusion on the deductibility of Superannuation Guarantee contributions for contractors deemed to be employees under section 12 of the SGA but may not have been either ‘employees’ or ‘eligible employees as defined in section 82AAA of the ITAA 1936 for the purposes of the existing subsection 82AAC(1) of the latter Act. The proposed subsection achieves this in **new subparagraph 82AAC(1)(c)(iii)** by linking the definition of an employee to the definition of employee in the SGA.⁶³

At first sight the language of **new subsection 82AAC(1)** appears not to achieve its intended outcome. **Sub-paragraphs 82AAC(1)(c)(i) and (iii)** note that the deduction is available to employers where:

- (i) the other person was an eligible employee;
- (ii) the other person was an employee for the purposes of that [SGA] Act.

A question may arise over the use of ‘was’ in these sub-paragraphs. One reading of the proposed sub-section is that it may not support the employer receiving a tax deduction for Superannuation Guarantee contributions made in respect of current employees. Such a reading proposed sub-section 82AAC(1) would produce the perverse outcome that employers could not claim a tax deduction in respect of Superannuation Guarantee contributions made for current employees. This is clearly not the Government’s intention, and it would be in nobody’s interest to produce this result. To put the matter beyond doubt Members and Senators may care to consider whether a minor amendment to the above proposed sub-paragraphs may be necessary.

Items 2 to 13 generally replace the term ‘eligible employee’ or ‘employee’ with the term ‘person’ in the relevant sections of the ITAA 1936. These changes govern an employer in

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claiming a tax deduction for Superannuation Contributions made on behalf of either current or former employees. **Items 14 to 16** make similar changes to relevant sections of the ITAA 1997. All these items simply apply the previously existing rules governing the tax deductibility of Superannuation Guarantee Contributions for an employer to situations where these contributions are made in respect of former employees.

Items 17 and 18 ensure that Part 2 and Part 8 of the SGA apply in situations where Superannuation Guarantee payments are made by employers on behalf of former employees. Part 2 explains terms used in the Act and Part 8 deals with the payment of Superannuation Guarantee Shortfall amounts by the ATO to the employee's, or former employee's, superannuation fund/account.

Endnotes

- 1 Selection of Bills Committee, Report No. 12 of 2005, Appendix 3, 11 October 2005, http://www.aph.gov.au/Senate/committee/selectionbills_ctte/reports/2005/rep1205.pdf
- 2 ITAA 1997, s. 165-12.
- 3 ITAA 1997, ss. 165-13, 165-15.
- 4 ITAA 1997, Division 166.
- 5 Senator Helen Coonan, Minister for Revenue, Improved Tax Loss Recoupment Rules for Companies, [Press Release](#), Co21/04, 7 April 2004.
- 6 *ibid.*
- 7 *Explanatory Memorandum*, p. 4.
- 8 Budget 2005-6, available at <http://www.budget.gov.au/2005-06/bp2/html/revenue-03.htm>
- 9 Tax News Network Australia, New Measures to Improve Tax and Superannuation, at <http://www.taxnews.com.au/tls/public/TNNPublicStorage.nsf/0/d433377a36266ea1ca25707c007e98af?OpenDocument>, accessed 7 October 2005.
- 10 *Explanatory Memorandum*, p. 5.
- 11 27 October 2004.
- 12 The Hon. Peter Costello MP, Treasurer, [Income Tax Deductions to be Denied For Illegal Activities, Press Release](#), No. 038., 29 April 2005.
- 13 *Explanatory Memorandum*, p. 159. Section 26AAC discounts may be accessed if an ESS participant acquired shares on or before 6 p.m. on 28 March 1995. After that time, Division 13A provisions apply.
- 14 The Hon. Mal Brough, MP, House of Representatives, Debates, 14 September 2005, p.15.
- 15 The Superannuation Holding Account Special Account (SHASA) is a special account within the Commonwealth Consolidated Revenue Fund that acts as a destination of last resort for employers to pay Superannuation Guarantee amounts. For example, a person may work, say

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as a fruit picker, and suddenly leave that employer without providing a forwarding address or details of where to pay their Superannuation Guarantee entitlements. In these circumstances an employer could pay the employee's Superannuation Guarantee entitlements into SHASA to meet their obligations.

SHASA pays no interest, and does not charge any fees. The Australian Taxation Office is required to try and make regular efforts to contact individuals with monies in SHASA and arrange for these monies to be transferred into superannuation funds that pay a rate of return (and also charge a fee). It is to be closed to new contributions from 1 July 2006 (sections 1, 4 and 7 of the *Superannuation Legislation Amendment (Choice of Superannuation Funds) Act 2005*).

- 16 SGA, subs.23(6). The language of this Act has been extensively amended to refer to payments made in respect of each calendar year quarter.
- 17 SGA, s. 32.
- 18 SGA, s. 19.
- 19 SGA, ss. 31, 46.
- 20 ITAA 1936, s. 51(9).
- 21 SGA, s. 17.
- 22 SGA, s. 16.
- 23 SGA, s.65.
- 24 *Explanatory Memorandum*, p. 185 notes that the current view of the Australian Taxation Office (ATO) is that an employer has a Superannuation Guarantee obligation in respect of a former employee who is paid wages after they have ceased employment with that employer. However, the ATO's view until 5 November 2003 was that no Superannuation Guarantee obligation arose in these circumstances. See ATO Interpretative Decision 2003/36 (Withdrawn).
- 25 Exposure Draft Bill is available at:
<http://www.treasury.gov.au/contentitem.asp?NavId=021&ContentID=956>
- 26 Senator Helen Coonan, Minister for Revenue, Improved Tax Loss Recoupment Rules for Companies, op cit.
- 27 Senator Helen Coonan, Minister for Revenue and Assistant Treasurer, [Address to 2004 Corporate Tax Association Convention](#), Sydney, 3 May 2004.
- 28 Senator Helen Coonan, Minister for Revenue, Improved Tax Loss Recoupment Rules for Companies, op cit.
- 29 The Hon P Costello, Treasurer, Review of International Taxation Arrangements, [Press Release](#), No. 32 of 2003, 13 May 2003
- 30 The Hon M Brough, Assistant Treasurer, New Measures to Improve Tax and Superannuation, [Press Release](#), No. 82 of 2005, 14 September 2005.

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- 31 The Board of Taxation, [Review of International Taxation Arrangements—A Report to the Treasurer](#), Canberra, 2003, p. 106.
- 32 The Hon. Peter Costello MP, Treasurer, Income tax deductions to be denied for illegal activities, [Press Release](#), No. 038, 29 April 2005.
- 33 The Hon. Peter Costello, MP, Treasurer, [New Tax Treatment for Film Copyright](#), [Press Release No. 046](#), 10 May 2005.
- 34 Treasurer and Minister for Workplace Relation, Government Response to Nelson Report on Employee Share Ownership, [Joint Media Release](#), No. 014, 27 March 2003.
- 35 *ibid.*, p. 10.
- 36 The Hon. Peter Costello MP, Treasurer, Budget Paper No. 2 2005–06, Budget Measures 2005–06, p. 35.
- 37 Allesandro Fabro, [Tax-loss rule changes seen as a ‘mixed blessing’](#), *Australian Financial Review*, 16 September 2005, p.5.
- 38 *ibid.*
- 39 Allens Arthur Robinson, ‘Focus: Tax focus on M&A’, June 2005, available at: <http://www.aar.com.au/pubs/tax/fotmajun05.htm>
- 40 PriceWaterhouseCoopers, The new loss recoupment rules for companies, 16 September 2005, available: [http://www.pwc.com/extweb/service.nsf/docid/d92586025619edcb8525666600203345/\\$file/TaxTalk_SpecialEdition_September2005.pdf](http://www.pwc.com/extweb/service.nsf/docid/d92586025619edcb8525666600203345/$file/TaxTalk_SpecialEdition_September2005.pdf)
- 41 *ibid.*
- 42 Allesandro Fabro, Tax-loss rule changes seen as a ‘mixed blessing’, *op cit.*
- 43 Allesandro Fabro, [Tax break gives multinationals a boost](#), *Australian Financial Review*, 21 June 2005, p. 10.
- 44 Allens Arthur Robinsons, Focus: Tax focus on M&A – June 2005, *op. cit.*
- 45 Peter Weeks, [Late super payment penalties altered](#), *Age*, 16 September 2005, p. 2.
- 46 Association of Superannuation Funds of Australia, *Good News for Employers, Employees on New Super Measures*, Media Release, 16 September 2005, available at: <http://www.asfa.asn.au/media/rpm.cfm?page=mr050916>
- 47 Peter Weeks, *op. cit.*
- 48 Mr Fitzgibbon, Debates, House of Representatives, *Debates*, 12 October 2005, p.6.
- 49 *ibid.*, p.7.
- 50 *ibid.* p.6.
- 51 *ibid.*
- 52 *ibid.*, p.8.
- 53 *ibid.*, p.15.

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- 54 *Explanatory Memorandum*, p. 116.
- 55 *ibid.*, p. 130.
- 56 *ibid.*, pp.132–4.
- 57 *ibid.*, p. 138.
- 58 *ibid.*, p. 5.
- 59 *ibid.*
- 60 *ibid.*, p. 160.
- 61 *ibid.*, p. 174.
- 62 *ibid.*, p. 161.
- 63 Stuart Jones, ‘Deductibility of Super Guarantee contributions for contractors’, *APT Weekly Tax Bulletin*, No 41, 30 September 2005, paragraph 1664.

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